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ORIGINAL

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF LAGO DEL ORO WATER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANTS AND PROPERTY AND FOR INCREASES IN ITS WATER RATES AND CHARGES FOR UTILITY SERVICE BASED THEREON.	DOCKET NO: W-01944A-13-0215

Arizona Corporation Commission
DOCKETED
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INITIAL CLOSING BRIEF

May 5, 2014

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TABLE OF ABBREVIATIONS AND CONVENTIONS

Lago Del Oro Water Company ("LDO" or "Company") uses the following abbreviations in citing to the pre-filed testimony in this brief. Other documents that were admitted as exhibits during the hearing are cited by hearing exhibit number. The final schedules setting forth the Company's final position will be cited in abbreviated format as "Company Final Schedule XXX."* Other citations to testimony and documents are provided in full, including (where applicable) the Commission's docket number and filing date.

LDO DEL ORO WATER COMPANY PRE-FILED TESTIMONY

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Direct Testimony of Ray Jones	**A-1**	Jones Dt.
Rebuttal Testimony of Ray Jones	**A-2**	Jones Rb.
Rejoinder Testimony of Ray Jones	**A-3**	Jones Rj.
Direct Testimony of Steven Soriano	**A-4**	Soriano Dt.
Direct Testimony of Thomas J. Bourassa – Rate Base	**A-5**	Bourassa Dt.
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Rebuttal Testimony of Thomas J. Bourassa – Cost of Capital	**A-8**	Bourassa COC Rb.
Rejoinder Testimony of Thomas J. Bourassa – Rate Base	**A-9**	Bourassa Rj.
Rejoinder Testimony of Thomas J. Bourassa – Cost of Capital	**A-10**	Bourassa COC Rj.

* LDO's final schedules are being filed currently with this Initial Closing Brief.

STAFF PRE-FILED TESTIMONY

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Direct Testimony of Mary Rimback	S-1A	Rimback Dt.
Direct Testimony of Michael Thompson	S-1B	Thompson Dt.
Direct Testimony of John Cassidy	S-1C	Cassidy Dt.
Direct Testimony of Mary Rimback – Rate Design	S-2A	Rimback RD Dt.
Direct Testimony of Michael Thompson – Cost of Service	S-2B	Thompson COC Dt.
Surrebuttal Testimony of Mary Rimback	S-3A	Rimback Sb.
Surrebuttal Testimony of John Cassidy	S-3B	Cassidy Sb.
Surrebuttal Testimony of Michael Thompson	S-3C	Thompson Sb.

OTHER PORTIONS OF THE RECORD

Document	Hearing Exhibit	Abbreviation
Revised Surrebuttal Schedule	S-4	
Permit for Well No. 19	A-11	
Compliance Status Report	A-12	
Transcript		Tr.

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Lago Del Oro Water Company ("LDO" or "Company") hereby submits its Initial Closing Brief in support of its request for a determination of the fair value of its utility plant and property and for the establishment of rates and charges for water utility service based thereon.[1]

I. OVERVIEW OF THE COMPANY AND THE REQUESTED RATE RELIEF

LDO provides water utility service to approximately 6400 customers in the SaddleBrooke community in Pinal County and the Catalina community in Pima County.[2] LDO uses groundwater as its source of water supply. Using a system of wells, storage facilities and booster stations, groundwater is distributed to its customers, which are almost entirely residential, throughout the Company's service area.[3] LDO pumps groundwater from 7 wells in its SaddleBrooke system, and from 9 separate wells in its Catalina system.[4] The Company is located within an Active Management Area (AMA) and is regulated by ADWR. The Company's water loss was under 7 percent during the test year.[5]

The current rates were approved in 1989.[6] There has been tremendous growth since the rates were approved, when there were only 700 customers in SaddleBrooke. Such growth, along with efficient management of operations, helped delay the need for new rates.[7] This, coupled with prior management's aversion to rate cases, led to the long

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[1] The key for defined terms, abbreviations and citations to a witnesses' pre-filed testimony is set forth in pages ii to iii following the Table of Contents. The table also lists the hearing exhibit numbers of the parties' pre-filed testimony. Except where noted, other hearing exhibits are cited by the hearing exhibit number and, where applicable, by page number, e.g., Ex.S-4 at 2. The transcript of the hearings is cited by page number, e.g., Tr. at 1.

[2] Soriano Dt. at 3:16-21.

[3] Jones Dt. 3:4 – 4:14.

[4] Thompson Dt., Engineering Report at 5.

[5] Thompson Dt., Engineering Report at 13.

[6] *See* Decision No. 56464 (April 26, 1989).

[7] Soriano Dt. at 4:1-14; Tr. at 56:22 – 57:22.

interval between rate cases.

The Company's application was filed on June 27, 2013, seeking a finding of fair value rate base and setting of rates thereon for water utility service. During the test year, LDO's adjusted gross revenues were $1,882,238.[8] The adjusted operating income was a negative $54,323 leading to an operating income deficiency of $658,175.[9] Obviously, the costs of goods and services have increased markedly since the late 1980s. In addition, the Company's rate base has increased by $7,264,262 (over 7000 percent) in the intervening years since the last rate case.[10] This includes more than $2.6 million of plant that was recently purchased by the Company from the developer of the SaddleBrooke community.[11] Thus, the rate of return on the Company's water operations during the test year was negative.[12]

In its Final Schedules, the Company requests a revenue requirement of $2,958,093.[13] This proposed revenue requirement is based on fair value rate base equal to $7,364,049, total operating expenses of $2,354,241, and a WACC equal to 8.2 percent on a capital structure made up of 71 percent equity and 29 percent debt.[14] The increase

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[8] Company Final Schedule A-1. The Company's final schedules have been filed concurrently with this closing brief.

[9] *Id.*

[10] The rate base was just $99,787 in the last case. *See* Decision No. 56464 at 4:3-5.

[11] As discussed below, earlier purchase of the plant from the developer was not possible given the Company's limited cash flow. Tr. at 53:23 – 54:18; 57:24 – 58:11. The shareholders recently provided the capital necessary to purchase this plant, and the Commission recently approved a loan to repay that capital and allow LDO to achieve a more balanced capital structure. Decision No. 74450 (April 18, 2014). No depreciation was previously taken on the recently purchased plant items, and LDO has agreed to include this plant in rate base at original cost less depreciation, which is more than $1 million less than the actual cost. *See* Bourassa Rb. at 15:3-13; Bourassa Rj. at 3:4-8; Tr. at 86:13 – 89:5.

[12] Company Final Schedule A-1.

[13] *Id.*

[14] Company Final Schedules A-1, C-1, page 1, & D-1, page 1.

requested constitutes an increase of $1,075,855 or 57.16 percent over test year revenues.[15]

II. ANALYSIS OF DISPUTED ISSUES

There were only a few issues in dispute between the Company and Staff by the time this matter went to hearing, and three of those issues are no longer in dispute. Specifically, LDO and Staff have now agreed (1) to include $7100 in the revenue requirement for annual audit costs; (2) to use Staff's 9.7 percent return on equity, which results in a rate of return equal to 8.2 percent; and (3) that the Company is now in compliance with ADWR which recently issued the permit for LDO's Well No. 19.[16] The Company's final schedules filed concurrently herewith reflect the resolution of the first of these two issues; the third does not impact the revenue requirement.

This leaves only three issues in dispute, and one of these issues – Staff's recommendation for BMPs, does not impact the revenue requirement. The two issues in dispute that impact rates are (1) Staff's use of vintage group depreciation to modify the Company's rate base and depreciation expense; and (2) Staff's failure to account for bonus depreciation in the ADIT calculation. These two issues taint Staff's recommended rate base and the Company's rate base should be adopted. Additionally, Staff's recommended BMP Tariffs are excessive and unnecessary and should also be rejected.

A. Disputed Issues Impacting Rates

As noted, LDO proposes a fair value rate base equal to $7,364,025, as compared to Staff's recommended fair value rate base of $7,366,456.[17] The parties' respective rate

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[15] Company Final Schedule A-1.

[16] Concurrently herewith, LDO has filed a Notice of Late Filed Exhibits. The two exhibits attached are a copy of the permit for Well No. 19 recently issued by ADWR, and a copy of a Compliance Status Report for LDO. These exhibits have been labeled as A-11 and A-12. Staff has both documents and has indicated it has no objection to admission of these late filed exhibits.

[17] Company Final Schedule A-1; Rimback Sb. at Schedule MJR-W1. The Company agrees that its original cost rate base should be used as its fair value rate base in this proceeding. Bourassa Dt. at 6:7-9.

bases reflect (1) LDO's acceptance of Staff's recommendation that the recently acquired plant be included in rate base at original cost less depreciation; and (2) Staff's agreement that the prior depreciation should be included in A/D.[18] The only differences in rate base relate to Staff's use of vintage group depreciation to reconstruct rate base and Ms. Rimback's belief that bonus depreciation is irrelevant. In the final analysis, Staff's recommended rate base suffers from a variety of maladies and the Commission should not adopt it.

1. Staff's Use of the Vintage Year Methodology has Caused Pointless Confusion and is Entirely Unnecessary.

Using the vintage group, Staff has come up with a \$371,263 reduction to A/D, an \$87,724 increase to net CIAC, and a reduction of \$40,587 to depreciation expense using the vintage group method.[19] But what Staff really has done is introduce additional complexity and confusion into the depreciation accounting without any corresponding benefit.

The Company uses the broad group method to depreciate its plant.[20] There is nothing unusual about this. As Staff admits, the broad group method is commonly used by Arizona utilities.[21] Under the broad group method, assets are grouped based on plant category (NARUC plant account) and then the entire group is tracked and depreciated.[22] Although the utility maintains property records for all plant items, individual assets are not tracked for depreciation. This is not unique to LDO; this is simply how the broad

[18] Bourassa Rb. at 8:7-23; Bourassa Rj. at 3:4-8; Rimback Sb. at 5:1-14. *See also* Tr. at 66:1-4.

[19] Bourassa Rb. at 9:1 – 14:17.

[20] Bourassa Rb. at 10:10-16. *See also* Tr. at 66:20 - 70:9.

[21] Tr. at 178:12-15.

[22] Tr. at 197:3 – 198:2.

group method works – assets are not broken down individually or into vintage groups.[23]

Staff's witness steadfastly maintained that she was required to reconstruct the Company's plant using the vintage group because the Company left fully depreciated plant unretired.[24] But there were no fully depreciated individual plant assets at the end of the test year.[25] This is why Ms. Rimback could not identify a single item of fully depreciated plant the Company tried to include in rate base.[26] Staff's recommendation is a solution in search of a problem, and a bad solution at that.

When Staff applied its vintage group procedure in the reconstruction of the Company's A/D balance to recognize Ms. Rimback's retirements, it created stranded negative accumulated depreciation vintage group amounts that were not depreciated (amortized).[27] The failure to amortize and recover the negative accumulated depreciation amounts is the reason Staff's A/D is understated.[28] Furthermore, these plant balances will become permanent rate base under the Staff approach.[29] In other words, Staff first created plant vintage groups using a different methodology, then recognized retirements to the vintage groups, creating in many cases, negative vintage group A/D balances which were ignored and left unamortized. The Staff approach results in permanent and positive net book value vintage group balances and thus permanent and positive rate base that the Company will likely have to address in the future. Mr. Bourassa is right – the whole thing makes no sense.

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[23] *Id.*

[24] *E.g.*, Rimback Sb. at 7:19-21; Tr. at 172:15-22.

[25] Bourassa Rj. at 6:20-21; Tr. at 66:20 – 67:13, 197:3 – 198:2.

[26] Tr. at 181:9 – 187:23.

[27] Bourassa Rb. at 11:19-21.

[28] Bourassa Rb. at 11:22 – 12:2.

[29] Bourassa Rj. at 5:1 – 6:19.

In the final analysis, there is very little difference in the revenue requirement from using Staff's vintage group results. The net increase to rate base under the Staff recommendation is $283,539 ($371,263 decrease to A/D minus $87,724 net increase to CIAC). This results in an increase to the Staff revenue requirement of about $35K. Staff's reduction in depreciation expense is about $41K; a net impact of about $6K ($35K minus $41k) on the revenue requirement or about a tenth of one percent. But bad ratemaking is still bad ratemaking. Because of its use of the vintage group procedure, Staff's rate base should not be adopted.

2. Bonus Depreciation Impacts ADITs; It is not "Irrelevant."

In his rebuttal testimony, Mr. Bourassa explained that LDO was proposing the Company reduce accumulated deferred income taxes ("ADIT") by $212,724, from $279,359 to $66,635.[30] This adjustment was necessitated by a change in the tax basis. Specifically, the tax basis changed because when the Company accepted Staff's reduced cost for the recently purchased plant items, there was a reduction in the net book value of the assets purchased from an affiliate.[31] For tax purposes, the tax basis now equals the net book value of the purchased assets of about $2.7 million rather than the full original cost as the Company proposed in direct of about $3.9 million. The tax basis also changes because the Company's bonus depreciation for 2012 was based upon the full original cost of the purchased plant of $3.9 million.[32] Since the full original cost of the plant was reduced by $1,136,587, then the basis reduction reflected in the ADIT computation is reduced by 50 percent or $568,294 ($1,136,587).[33]

[30] Bourassa Rb. at 14:19-23.

[31] Bourassa Rb. at 15:3-13.

[32] *Id.*

[33] *See* Company Final Schedules B-2, pages 7.0 & 7.1.

Staff did propose an adjustment to ADITs, however. Instead, Staff's witness testified that Staff "does not understand" Mr. Bourassa's rebuttal points regarding ADITs, and that bonus depreciation was "irrelevant" to the ADIT calculation and should be "disregarded."[34] If Staff did not understand the issue, it is difficult to understand how they could assert that bonus depreciation was irrelevant. But it is very relevant. The special bonus depreciation used in the ADIT computation of the net tax value of PIS has a *direct impact* on the ADIT balance.[35]

The Company illustrated this impact in its filings. In the Company's initial filing the bonus depreciation was computed on the plant acquired from an affiliate in 2012 equal to a net book value of $3,887,998 times 50 percent (or $1,943,999). In its rebuttal filing, by accepting Staff's position on the acquired plant, the Company was required to reduce the book value of this plant by the depreciation the Company would have recorded if the plant were booked at the time the plant was placed into service.[36] When the net book value changed from $3,888,998 to $2,751,411, the Company's net tax value and the basis for computing bonus depreciation was no longer $3,887,998, but rather the net book value of this plant or $2,751,411 ($3,887,998 minus $1,136,587).[37] Accordingly, the maximum amount of bonus depreciation on this plant for tax purposes is reduced by $568,293, from $1,943,999 to $1,375,706 ($2,751,411 times 50%).[38] To use more than $1,375,706 for bonus depreciation, which Staff did in this case, results in an overstatement of ADITs and an understatement of rate base. For this additional reason, Staff's rate base should be rejected and the Company's adopted.

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[34] Rimback Sb. at 8:8-18.

[35] Bourassa Rj. at 8:2-6.

[36] Bourassa Rj. at 8:6-18.

[37] *Id.*

[38] Bourassa Rb. at 15.

B. BMPs – The Commission Should Reject Duplicative and Excessive Regulation, Again.

LDO supports water conservation. As mentioned, the Company is located in an AMA and is subject to ADWR's requirements for the development and implementation of Best Management Practices (BMPs).[39] LDO has five BMPs that were approved by ADWR in August, 2009. In addition to these approved BMPs, LDO has implemented a Public Education Program.[40] The Company also provides "Water Wise" tips to customers on monthly bills and provides conservation brochures throughout its service area and upon request.[41] The Company files reports on its conservation activities with ADWR.

Over the past few years, the Commission has repeatedly recognized that regulating groundwater protection is the province of ADWR, not the Commission.[42] In fact, it has been specifically held that it would be duplicative and contrary to the public interest for the Commission to also require BMPs from the public service corporations it regulates.[43] Despite these recent holdings, Staff stubbornly continues to recommend that water utilities in rate cases file BMPs. This recommendation should be rejected, again.

Staff's recommendation is more than duplicative; it's excessive. Adoption of the recommendation would require the Company to modify its existing BMPs to fit Staff's one-size fits all tariff format, and to adopt more BMPs than are required by ADWR.[44] But Staff's only reason for recommending excessive and duplicative regulation – it is Staff's policy to recommend BMPs for all water utilities that come in for rate cases.[45]

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[39] Jones Dt. at 4:23 – 5:20.

[40] *Id.*

[41] *Id.*

[42] *See* Jones Rj. at 4:17 – 5:7 *citing* two recent Commission decisions.

[43] *Id.*

[44] Jones Rb. at 4:8-16. Staff initially wanted 7 BMPs, but clarified to 6, which is still one more than the 5 required of the Company by ADWR.

[45] Tr. at 117:7-17.

In other words, this has nothing to do with LDO, its need for water conservation or its track record implementing existing water conservation measures. This is about Staff and its view that it knows better than the Commission and ADWR, and its desire to expand the reach of the Commission. The Commission has consistently disagreed with this view of Staff. It should do so again in this case.

III. <u>CONCLUSION</u>

Based on the foregoing, LDO respectfully requests the following relief:

a. A finding that the fair value of LDO's property devoted to water utility service is $7,364,049;

b. Approval of an overall rate of return on such rate base equal to 8.20 percent;

c. A determination of a revenue requirement for LDO of $2,958,093, which constitutes increases over adjusted test year revenues of $1,075,855 or 57.16 percent over the test year;

d. Approval of rates for water utility service designed to allow the Company to recover such revenue requirement; and

f. Such other and further relief as the Commission deems appropriate to implement the relief requested herein.

RESPECTFULLY SUBMITTED this 5th day of May, 2014.

FENNEMORE CRAIG, P.C.

By______________________________

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